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# In the Supreme Court of the United States

## No. 430.

**OCTOBER TERM, 1946.**

UNITED STATES OF AMERICA,
*Petitioner,*

vs.

OGILVIE HARDWARE COMPANY, INC.,
*Respondent.*

ON PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES CIRCUIT COURT OF APPEALS
FOR THE FIFTH CIRCUIT.

## BRIEF OF AMICUS CURIAE, THE VAUGHN MACHINERY COMPANY.

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## BRIEF OF AMICUS CURIAE, THE VAUGHN MACHINERY COMPANY.

### PRELIMINARY STATEMENT.

This controversy is between the United States of America and Ogilvie Hardware Company, Inc. A decision, however, by this Court on the question presented herein will vitally affect the rights of The Vaughn Machinery Company, which has filed an action against the United States of America in the Northern District of Ohio, Eastern Division, Civil Action File No. 23404, for a refund of income taxes (Surtax on Undistributed Profits) erroneously paid. That action involves the issue presented to this Court for determination in the instant case, viz., the effect of the issuance of a nontaxable stock dividend on the right of a corporation to a credit against surtax, under Section 26(c)(3) of the Revenue Act of 1936 as added by Section 501 of the Revenue Act of 1942.

In view of the fact that the decision of this Court might be determinative of the rights of The Vaughn Machinery

Company in its suit against the United States of America, The Vaughn Machinery Company has requested and secured the consent of petitioner's and respondent's counsel to file a brief amicus curiae in this action.

## QUESTION PRESENTED.

Whether the phrase "deficit in accumulated earnings and profits," as used in Section 26(c)(3) of the 1936 Revenue Act, as amended,

(1) is to be accorded its common generic meaning, so as to refer to all earnings deficits

or

(2) is to be restricted so as to cover only certain earnings deficits, and so as to exclude that portion of such deficits arising from non-taxable stock dividends.

## ARGUMENT.

### IF A CORPORATION ISSUES A NONTAXABLE STOCK DIVIDEND AT A TIME WHEN IT HAS A SURPLUS, AND SUBSEQUENTLY A DEFICIT IS CREATED BY OPERATING LOSSES, THAT CORPORATION IS A "DEFICIT CORPORATION" WITHIN THE MEANING OF 26(c)(3) OF THE REVENUE ACT OF 1936 AS ADDED BY SECTION 501 OF THE REVENUE ACT OF 1942.

Section 14 of the Revenue Act of 1936 imposed a surtax on the net income of a corporation in an amount measured by the undistributed net income. Section 14 defined "undistributed net income" as meaning adjusted net income minus the credits provided by Sections 27 and 26(c). Section 26(c) allowed a credit for written contracts executed by a corporation prior to May 1, 1936, restricting the payment of dividends. This credit provision was strictly construed so as to preclude from its benefit deficit corporations which were prohibited by *state law* from paying dividends other than from surplus. In *Helvering v. Northwest Rolling Mills Company*, 311 U. S. 46, the Supreme Court held that

neither state laws of the character indicated, nor corporate charters, were a "written contract executed by the corporation prior to May 1, 1936" within the meaning of Section 26(c)(1) of the Revenue Act of 1936.

As a result of this decision, many corporations with impaired capital, prohibited by state law from paying dividends, were, nevertheless, subject to the Undistributed Profits Surtax on current earnings. Corporations and their directors were, therefore, placed in an anomalous position by the failure of Congress explicitly to grant a credit to corporations for earnings, the distribution of which was prohibited by state law. If a corporation declared improper dividends, both it and its directors would be liable under state law; if it failed to do so, it would be liable for a Surtax on Undistributed Profits under Section 14 of the 1936 Revenue Act.

It was for the express purpose of remedying this situation that Congress in 1942 enacted Section 501, which added subdivision (3) to Section 26(c) of the 1936 Revenue Act. Section 26(c)(3), as so amended, then allowed the following credit:

> "(3) Deficit Corporations.—In the case of a corporation having a deficit in accumulated earnings and profits as of the close of the preceding taxable year, the amount of such deficit, if the corporation is prohibited by a provision of a law or of an order of a public regulatory body from paying dividends during the existence of a deficit in accumulated earnings and profits, and if such provision was in effect prior to May 1, 1936."

This brings us to a consideration of the significance of the phrase "deficit in accumulated earnings and profits." The Government takes the position that this phrase should be read: "*some kind* of deficits in accumulated earnings and profits." It superimposes a technical, restrictive gloss on the common meaning of the phrase: "deficit in accumulated earnings and profits;" by reducing

such earnings deficits by nontaxable stock dividends the petitioner, in effect, denies that the phrase means what it says. Petitioner would restrict it to *some* earnings deficits.

As opposed to the Government's refusal to apply this phrase as it reads, we have the following considerations:

(1) The phrase: "deficit in accumulated earnings and profits" is plain and unambiguous and may not be limited to deficits arising in a particular manner.

(2) Since the language of Section 501 of the Revenue Act of 1942 is clear and unambiguous, it requires no reference to extraneous aids for its construction.

(3) If extraneous aids are used and Section 501 is construed to carry out Congress' purpose, "deficit in accumulated earnings and profits" can not be limited to some kinds of earnings deficits.

(4) Section 115(h) of the 1936 Revenue Act has no application to the credit granted corporations by Section 501 of the Revenue Act of 1942.

(5) The phrase: "deficit in accumulated earnings and profits", when given its commonly accepted construction has independent significance.

**Point (1). The phrase: "deficit in accumulated earnings and profits" is plain and unambiguous and may not be limited to deficits arising in a particular manner.**

The term "deficit in accumulated earnings and profits" has a well-understood meaning. It relates to a corporation whose earned surplus has been depleted to such an extent that its capital is impaired. It is immaterial under state laws prohibiting the payment of dividends out of capital that the corporation's deficit has been caused in a particular manner or is the result of certain transactions. The important factor is that the corporation no longer has earnings and profits *available for distribution under state laws.*

The fact that a portion of a corporation's deficit is the result of a nontaxable stock dividend issued at a time when the corporation did have accumulated earnings and profits available for distribution does not render a corporation any less amenable to state laws prohibiting dividend payments to corporations with earnings deficits.

There is nothing in the language of Section 501 of the 1942 Revenue Act to suggest even faintly that Congress intended to limit the words "deficit in accumulated earnings and profits" to only *certain kinds* of earnings deficits. If Congress had intended to limit the credit to those corporations whose deficits had been caused in a particular manner, it would have been a simple matter for it to do so. Congress having failed to restrict expressly the operation of the credit, the Government cannot now claim that the meaning of the words "deficit in accumulated earnings and profits" is one other than its plain and obvious one and is limited to *some types* of such deficits.

Stripped down to its essentials, the petitioner's argument necessarily comes down to this: "A corporation has a deficit. The deficit was caused in a certain way. Therefore, the corporation has no deficit." *That a deficit was caused in a certain manner, however, does not contradict the existence of the deficit.*

The Fifth Circuit Court of Appeals, in affirming the judgment of the District Court in the instant case, specifically considered the meaning to be attached to the words "deficit in accumulated earnings and profits" as used in Section 501 and reached the following conclusion (155 F. (2d) 577, 579):

> "*Turning to the words in the federal amendment, 'a deficit in accumulated earnings and profits,' they are not specially defined and ought to have their natural, common meaning.* They occur twice in the single clause of the amendment. In the second occurrence the context is, 'the corporation is prohibited by law from paying dividends during the existence of a

deficit in accumulated earnings and profits.' *Clearly the deficit here referred to is that which the state law makes a deficit in prohibiting the payment of dividends.* We see no propriety in construing a different meaning in their first occurrence. 'In the case of a corporation having a deficit in accumulated earnings and profits.' It is the same corporation in the same condition that is referred to. * * * *There is no justification for saying that in the last quoted phrase the deficit meant is that which may be figured by adding all the earnings and profits the corporation has made since its beginning and subtracting only what has been paid out in taxable dividends.*" (Emphasis supplied.)

**Point (2). Since the language of Section 501 of the Revenue Act of 1942 is clear and unambiguous, it requires no reference to extraneous aids for its construction.**

It is well understood that resort will not be had to extraneous aids to legislative construction (e.g., Congressional committee reports, Commissioner's Regulations, etc.) where they purport to construe provisions of an act which are free from ambiguity and doubt. Such a principle would apply in the instant controversy in view of the clear and unambiguous language employed by Congress.

In *Koshland v. Helvering*, 298 U. S. 441, 446-47, the Supreme Court clearly enunciated the rule in these words:

> "Where the Act uses ambiguous terms or is of doubtful construction, a clarifying regulation, or one indicating the method of its application to specific cases, not only is permissible but is to be given great weight by the courts. And the same principle governs where the statute merely expresses a general rule and invests the Secretary of the Treasury with authority to promulgate regulations appropriate to its enforcement. *But where, as in this case, the provisions of the Act are unambiguous, and its direction specific there is no power to amend it by regulations.*" (Emphasis supplied.)

In *United States v. Mo. Pac. R. Co.*, 278 U. S. 269, 278, the following statement as to the use of extrinsic aids when the language of a statute is clear and unambiguous is particularly apposite:

> "Where doubt exists and construction is permissible, reports of the committees of Congress and statements by those in charge of the measure and other like extraneous matter may be taken into consideration to aid in the ascertainment of the true legislative intent. But *where the language of an enactment is clear and construction according to its terms does not lead to absurd or impracticable consequences, the words employed are to be taken as the final expression of the meaning intended.* And in such cases legislative history may not be used to support a construction that adds to or takes from the significance of the words employed." (Emphasis supplied.)

Not only is the phrase: "deficit in accumulated earnings and profits" clear, but "construction according to its terms does not lead to absurd or impracticable consequences." On the other hand, *the petitioner's restrictive gloss would "lead to absurd or impracticable consequences."* Suppose a corporation with $100,000 capital and $150,000 earned surplus declared a stock dividend in 1912, with resulting $200,000 of capital and $50,000 of surplus. On December 31, 1936, its surplus is nonexistent and its capital is impaired by $10,000. In 1937 its net income is $9,000. The petitioner would not permit a credit for the amount of the December 31, 1936 "deficit in accumulated earnings and profits." Petitioner would have the corporation pay a Surtax on Undistributed Profits even though it winds up the year with impaired capital and with a "deficit in accumulated earnings" by any reasonable construction of the phrase.

**Point (3). If extraneous aids are used and Section 501 is construed to carry out Congress' purpose, "deficit in accumulated earnings and profits" can not be limited to some kinds of earnings deficits.**

Assuming *arguendo* that the Congressional Committee Reports can be taken into consideration to assist in ascertaining the meaning of the amendment herein involved, an examination of the Senate Finance Committee Report on the 1942 Revenue Bill does not reveal any information that supports the Government's position; on the contrary, it lends further support to our interpretation of the application of the amendment. The pertinent parts of that Report are the following (Senate Report No. 1631, 77th Cong., 2d Sess., 245-46):

> "Under section 14 of the Revenue Act of 1936 corporations in general were subject to surtax at various rates from 7 to 27 percent of their undistributed net income. *In some instances State law or an order of a public regulatory body prohibited payment of dividends during the existence of a deficit even though the corporation had current earnings and profits which would constitute undistributed net income under the definition thereof in section 14(a)(2).* Such corporations were, therefore, subject to undistributed profits surtax even though they were prohibited by law from paying dividends. The addition of the new paragraph 3 to subsection (c) of section 26 to provide an additional credit in the amount of the deficit in accumulated earnings and profits as of the close of the preceding taxable year is intended to give relief in certain of these cases." (Emphasis supplied.)

The Report clearly states that Section 501 is intended to give relief to those corporations which were prohibited by state law from paying dividends during the existence of a deficit in accumulated earnings and profits. *It makes no reference to limiting "deficit in accumulated earnings and*

*profits" to one caused solely by operating losses or by the issuance of a taxable dividend.*

We can, therefore, conclude that in view of the unambiguous language employed in Section 501 and in view of Congress' purpose in granting this relief, the words "deficit in accumulated earnings and profits," require a construction which gives effect to their plain and ordinary meaning. That is, the benefit of Section 501 is intended to cover those corporations prohibited by state law from paying a dividend during the existence of a deficit in accumulated earnings and profits regardless of the *cause* of that deficit.

**Point. (4). Section 115(h) of the 1936 Revenue Act has no application to the credit granted corporations by Section 501 of the 1942 Act.**

The Government contends that Section 115(h) of the Revenue Act of 1936 supports its position that a deficit in earnings and profits must be reduced by nontaxable stock dividends in arriving at the credit for such deficit under Section 26(c)(3). Section 115 reads in part as follows:

"Sec. 115. DISTRIBUTIONS BY CORPORATIONS.

"(h) *Effect on Earnings and Profits of Distributions of Stock.*—The distribution (whether before January 1, 1936, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities or stock or securities in another corporation shall not be considered a distribution of earnings or profits of any corporation—(1) if no gain to such distributee from the receipt of such stock or securities was recognized by law, or (2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115(f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act."

As can readily be observed from the foregoing, Section 115(h) deals exclusively with the tax liability of *stockholders*; it has no relation to a *corporation's* liability for taxes. A reading of *all* of Section 115 indicates that it is concerned exclusively with the characterization of corporate distributions to *stockholders*: whether the distributions are taxable and, if so, whether the income is ordinary or capital. Subdivision (h), a part of Section 115, limits the usual meaning of "earnings or profits" *as used in Section 115(a), (b), and (g), in determining whether corporate distributions constitute ordinary dividends in the hands of stockholders.*

In *United States v. Byron Sash & Door Co.*, 150 F. (2d) 44, the precise issue now before this Court was presented, and the Sixth Circuit Court of Appeals came to the same conclusion as did the Fifth Circuit Court of Appeals in the instant case, that is, the conclusion advocated by amicus curiae. In discussing the effect of Section 115(h), the Sixth Circuit Court of Appeals declared (at page 46):

> "Section 115(h) deals with the taxable status of the *stockholder* who receives the stock dividends, rather than with the liability of the *corporation* for tax, and to use this provision of the statute in order to ignore the deficit in the case before us, and to deny credit on undistributed profits surtax to this corporation seems untenable." (Emphasis supplied.)

A like construction as to the inapplicability of this Section to the credit provided in Section 501 of the 1942 Revenue Act was expressed by the Circuit Court of Appeals below in the instant case (155 F. (2d) 577, 580):

> "This section has reference not to the taxes or credits of the corporation, but only to the taxation of a shareholder as a reading of the whole section will show. * * * We do not think this provision has any bearing on the 1942 amendment under discussion, which relates to the taxation of the corporation itself for not distributing its current income."

Even more recently, in *Philadelphia Carpet Co. v. United States*, 68 Fed. Supp. 712 (D. C. E. D. Pa. 1946) the Court followed the *Byron Sash & Door* and the *Ogilvie Hardware Co.* cases for the reasons therein expressed by the Sixth and Fifth Circuit Courts of Appeals.

The only case in which an issue somewhat similar to the one before this Court has been decided in favor of the Government is *Century Electric Company v. Commissioner*, 144 F. (2d) 983 (CCA 8th, 1944). It is difficult to determine from the opinion in that case the exact facts involved. The opinion, however, indicates that the stock dividend was distributed in the taxable years there at issue and does suggest that a capital deficit remained immediately following the stock dividend, and that, therefore, the dividend was the *direct* cause of the deficit. If this were the state of facts in the *Century Electric* case, then it is clearly distinguishable from the facts involved in the present controversy, as the Court in the *Byron Sash* case, *supra*, at page 46, clearly points out:

> "In other words, the Court (in the *Century* case) held that where a corporation had a surplus, a deficit within the meaning of the statute under which a credit is allowed, could not be effected by the distribution of a non-taxable stock dividend. In the *Century Electric* case, there was, therefore, no deficit but rather a surplus as of the close of each of the two taxable years preceding the distribution of the dividends, and, accordingly, no credit was allowed by the provisions of the statute. See also the report of the same case, *Century Electric Co. v. Commissioner*, in 3 T. C. 297. *The obvious difference between the Century case and the one before us is that in the former the claimed deficit was effected by the distribution of the stock dividends, while in the instant case, it was effected by the preceding seven years of operating losses.*" (Emphasis supplied.)

While, therefore, this Court might distinguish between the effect of a stock dividend leaving a surplus which is

subsequently wiped out by operating losses, and a stock dividend which itself wipes out a surplus, the clear language of Section 26(c)(3), as well as Congress' purpose in enacting it, permits of no limitation on "deficit in accumulated earnings and profits" in either situation. The precise facts of the instant case, however, do not require so broad a finding.

We have already indicated that in view of the unambiguous language of Section 501 extrinsic matter such as Committee Reports cannot properly be employed to support a construction not otherwise indicated by the words used. The Committee Reports on the 1942 Revenue Bill, however, further emphasize the inapplicability of Section 115(h) of the 1936 Act to the 1942 amendment which added Section 26(c)(3) to the 1936 Act. We will refer here once again to the Report of the Senate Finance Committee on the 1942 Revenue Bill, this time in particular to its reference to Section 115 of the 1936 Revenue Act. *That reference to Section 115 is completely unrelated to the 1942 Act's addition of Section 26(c)(3) to the 1936 Act*; as will be seen, the sole reference to Section 115 was in connection with a completely different amendment.

The only reference to Section 115 in the Senate Finance Committee Report appears in Senate Report No. 1631, page 245. It reads as follows (quoted here at length—although it has no bearing at all on the instant question—only because the Government has relied on this Report and only in order to demonstrate that Section 115(h) was never intended to limit "deficit in accumulated earnings and profits" to *certain* kinds of such deficits):

> "Also under section 14 of the Revenue Act of 1936, it was possible that the undistributed net income of a corporation might exceed accumulated and current earnings and profits. In such case the tax could not be avoided even if distributions were made to shareholders. This result was primarily due to the fact that section 117(d) of the Revenue Act of 1936 limited

capital losses to $2,000 and section 27(a) and (b)* operated to disallow any credit where a distribution did not constitute a taxable dividend. Section 115 of the act provided that the term 'dividend' means a distribution from earnings or profits, either those accumulated after February 28, 1913, or those realized during the current taxable year. The purpose of the undistributed profits tax was to force the payment of taxable dividends. Where a corporation has no earnings or profits, it cannot make a taxable distribution which would constitute a dividend allowable as a dividends-paid credit in computing the undistributed net income subject to the surtax."

The foregoing explanation was devoted to the following difficulty under the unamended 1936 Act: A corporation could find itself in the position where its adjusted net income subject to the Undistributed Profits Surtax could not be reduced by a dividends paid credit—this because a "dividend" could be counted as such under Section 115(a) (and therefore as a credit against "adjusted net income") only to the extent of a corporation's accumulated or current year's "earnings or profits"; in certain situations "earnings or profits" were a smaller figure than "adjusted net income," as, for example, when a corporation had capital losses deductible in arriving at the former but not in computing the latter; in such a case, the dividends paid credit—because of the provision of Section 115(a)—could not equal the adjusted net income.

The allusion to Section 115 in the Senate Finance Committee Report quoted above is in connection with the amendment which augmented the credit by the excess of adjusted net income over the possible dividend paid credit. We quote that amendment by Section 501 of the 1942 Act, adding to the 1936 Act Section 26(f) (but, again, only to demonstrate that the amendment, together with the Committee's reference to Section 115, has absolutely no bear-

* This is obviously an error and should read "(h)."

ing on the other amendment in which we are interested in this case, and which added Section 26(c)(3)):

> "(f) Deficit Credit.—The amount by which the adjusted net income exceeds the sum of (1) the earnings and profits accumulated after February 28, 1913, as of the beginning of the taxable year, and (2) the earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year) * * *."

It is only in connection with the foregoing amendment that Senate Report No. 1631 mentions Section 115 of the 1936 Act and then only to define the word "dividend." It is apparent, therefore, that this reference to Section 115 is limited to this particular amendment adding subsection (f) to Section 26 of the 1936 Act. It was not intended to apply to that amendment adding Section 26(c)(3) which granted a credit to deficit corporations prohibited by state law from paying dividends during the existence of a deficit.

This analysis is substantiated by a reading of the House Ways and Means Committee Report on the 1942 Revenue Bill (House Report No. 2333, 77th Cong., 2nd Sess., page 170), which is substantially the same as the Senate Report, quoted above.

Section 501 of the 1942 Act, as *originally* passed by the *House*, did *not* contain the provision that a corporation with a deficit in accumulated earnings and profits was entitled to a credit against surtax if it were prohibited by state law from paying dividends during the existence of such a deficit; that is, it did not add subdivision (3) to Section 26(c) of the 1936 Act. The House 1942 Bill did, however, contain the amendment adding Section 26(f). It follows even more clearly, therefore, that the Ways and Means Committee Report reference to Section 115 had nothing whatever to do with the later amendment *by the Senate* which added subdivision (3) to Section 26(c). The Senate Bill not only added Section 26(f), as did the

House Bill, but also added subdivision (3) to Section 26(c), granting relief to corporations prohibited by state law from paying dividends. The Senate Report, in referring to Section 115 of the 1936 Act, adopted the language of the House Report. We can, therefore, conclude that the Senate Committee intended to confine its discussion of Section 115 to the very thing to which the House Report did, namely, Section 26(f). It would be absurd to claim that this discussion has reference to subdivision (3) of Section 26(c), when that provision never even appeared in the House Bill.

It will be seen, therefore, that the reference to Section 115 in the House and Senate Reports does not relate at all to the amendment adding subdivision (3) to Section 26(c), and this is borne out both by the wording itself of those Reports, as well as by the legislative progress of Section 501 of the 1942 Revenue Bill.

**Point (5). The Phrase: "deficit in accumulated earnings and profits" when given its commonly accepted construction has independent significance.**

The Government might take the position that a common-sense interpretation of the phrase: "deficit in accumulated earnings and profits" reduces it to insignificance because—so might run the Government's argument—Section 26(c)(3) would then give relief in all cases when local law prevents corporate distributions. That is not the case. The phrase has vitality even when given its ordinary meaning for at least two reasons.

In the first place, the phrase, "deficit in accumulated earnings and profits," operates independently as a *measure* of the *credit* afforded by Section 26. The pattern of the 1936 Act's treatment of the Surtax on the Undistributed Profits clearly explains the phrase's significance, without benefit of any artful, technical, restrictive gloss. Section 14 imposes a tax measured by "undistributed net income."

"Undistributed net income" is computed after adjustment for "the credit provided in Section 26(c)," or, in simpler words, after certain subtractions. Subsections (1) and (2) of Section 26(c) as originally enacted started off, naturally enough, with subtractions for: "An amount equal to * * *" etc., etc. Similarly, subdivision (3) allows a subtraction: "In the case of a corporation having a deficit in accumulated earnings" of "the amount of such deficit" providing local law prohibits the distribution.

Take Example (1) of Article 26-2 of the Commissioner's own Regulations 94:

> "The M Corporation for the calendar year 1936 had an adjusted net income of $200,000 but had an actual deficit in accumulated earnings and profits as of December 31, 1935, of $20,000. By reason of a State law in effect prior to May 1, 1936, with respect to deficit corporations, the M Corporation was prohibited from paying dividends during the existence of such deficit. Under section 26(c)(3), the M Corporation is allowed a credit of $20,000."

So the reference to earnings deficits *measures* the credit—and this quite apart from the requirement of a local law prohibition; indeed, the "deficit" language of Section 26(c)(3) operates so that some corporations prohibited by state law from paying dividends, derive a *credit less than their adjusted net incomes*—as witness the very example above.

In the second place, the local prohibition requirement relates broadly to dividends being precluded by "a law or * * * an order of a public regulatory body." Such a broad prohibition, standing alone, would sometimes operate even when there were no capital impairment in the usual, conventional sense. The requirement that there be a deficit in earnings operates independently to deny relief, therefore, in many specialized situations, as for example, where public utilities commissions prohibit dividend payments in certain particular situations; public regulatory

bodies often prohibit dividend payments although there is no deficit in earnings in the conventional sense. Our construction of "deficit in accumulated earnings" therefore gives the phrase independent meaning.

In light of the foregoing, we respectfully submit that the decisions of the Fifth and Sixth Circuit Courts of Appeals give to the phrase: "deficit in accumulated earnings and profits," its common, everyday, generic meaning, and that those decisions carry out the intention of Congress to afford relief from the penalty Surtax on Undistributed Profits.

## CONCLUSION.

The judgment appealed from is correct and should be affirmed.

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